



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
BAY AREA DRYWALL, INC.)

Appearances:

For Appellant: W. Richard Mills, Certified
Public Accountant

For Respondent: Peter S. Pierson
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Bay Area Drywall, Inc., against a proposed assessment of additional franchise tax in the mount of \$898.64 for the income year 1963.

Appellant, a California corporation, was formed in 1955 and engaged in the business of dry wall construction. In computing its income, it used the specific charge-off method of accounting for bad debts, deducting debts as they became worthless. Its franchise tax returns reflected the use of that method.

On February 28, 1961, appellant filed a petition in bankruptcy. It did no business in 1962. It filed a franchise tax return for the income year 1962 in which no income was reported.

For the income year 1963, appellant filed a franchise tax return in which it used the reserve method of accounting for bad debts. Under that method, a reserve is established

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representing an estimate of the percentage of outstanding debts that will become worthless in the future. As the volume of outstanding debts increases, additions are made to the reserve and are deducted from income. Appellant did not request respondent's permission, to change to the reserve method.

Respondent disallowed the deduction taken by 'appellant on the reserve method on the ground that appellant did not request permission to change its method of accounting for bad debts as required by respondent's regulations.

Section 24348 of the Revenue and Taxation Code provides that "There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts,"

Respondent's regulations provide that:

Bad debts may be treated in either of two ways

(1) By a deduction from income in respect of debts which become Worthless in whole or in part, or

(2) By a deduction from income of an addition to a reserve for bad debts.

A taxpayer filing a first return of income may select either of the above two methods subject to approval by the Franchise Tax Board upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Franchise Tax Board to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the income year for which the change is to be effective, (Cal. Admin. Code, tit. 18, reg. 24121f(1), subd. (b).)

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Appellant argues that its return for the income year 1963 was equivalent to a first return of a commencing corporation because the return was filed after appellant's bankruptcy and after a period of inactivity. It concludes, therefore, that its election to use the reserve method in that return was authorized by respondent's regulation. It also states that the purpose of requiring permission to change methods of accounting for bad debts is to prevent duplication or omission of items of income or expense. Under the particular facts of its case, says appellant,, no such duplication or omission occurred and, accordingly, its use of the reserve method was proper,

In our opinion, the return filed by appellant for the income year 1963 was not its "first return" within the meaning of the pertinent regulation. That return was not literally its "first return," because it had previously filed returns. Upon resuming business after a period of inactivity, appellant was not a "commencing corporation" for other purposes of the franchise tax law. (Rev. & Tax. Code, §§ 23222, 23281.) Insofar as the possibility of duplications or omissions is concerned, moreover, a corporation changing methods of accounting for bad debts upon resuming business is not in the same class as a corporation making its initial election of a method,

Since the 1963 return was not appellant's first return and since it had used the specific charge-off method in prior returns, the next question is whether it could validly change to the reserve method without requesting permission as specified in respondent's regulation.

By requiring advance permission to change to the reserve method, respondent is given a timely opportunity to exercise its statutory discretion by determining whether the new method is appropriate to the type of business and whether adjustments are necessary to prevent duplications or omissions. The requirement allows respondent to weigh, before the change is made, facts such as appellant's bankruptcy and its temporary cessation of business. The requirement is within respondent's discretion, is clearly spelled out in the regulation, and may not be ignored. (Key Manufacturing Co., 18 B.T.A. 753, aff'd, 53 F.2d 1083.)

Our decision in Appeal of Culver Federal Savings and Loan Ass'n, Cal. St. Bd. of Equal., Feb. 14, 1966, is cited by appellant but it is readily distinguishable. Permission to

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use the **reserve** method was unnecessary in that case because the taxpayer had not previously incurred any bad debts and had not previously elected to use any method of accounting for them. Here, appellant elected to use the specific charge-off method long before it attempted to change to the reserve method.

Since appellant failed to comply with the authorized and unambiguous requirement that it request permission to change to the reserve method of accounting for bad debts, respondent's disallowance of a deduction under that method must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Bay Area Drywall, Inc., against a proposed assessment of additional franchise tax in the amount of \$898.64 for the income year 1963, be and the same is hereby sustained.

Cone at Sacramento, California, this 1st day
of September, 1966, by the State Board of Equalization.

[Signature], Chairman
John W. Lynch, Member
Paul R. Lewis, Member
John H. [Signature], Member
[Signature], Member

ATTEST: [Signature], Secretary